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THE TREATMENT OF PROVISIONS IN THE NATIONAL ACCOUNTS: ELEMENTS FOR THE REVIEW OF THE SNA

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The aim of this paper is to launch a discussion on the general treatment of *provisions* and *impairment of assets* in the National Accounts, in the context of the review of the SNA. The paper argues that the SNA should recognize the *provisions* and *impairment of assets* that are recognised by business accounting standards, instead of, as currently, rejecting these items outside the scope of the accounts.

The paper proposes the creation of new lines in the sequence of account, located just before the balance sheet accounts, where the SNA would record *changes in provisions* and *impairment of assets*. Also, the stock of *provisions* and *impairment of assets* would be available in the annual balance sheet accounts. Both these pieces of information would come as an additional information to the existing tables.

Far from being a revolution, this proposal would simply allow users to compile alternative values for the net worth of institutional sectors, including or excluding these items. One specific property of this additional information is that the tables would not be fully symmetrical. It is a small price to pay compared to the advantage of extending the scope of the SNA to these important accounting entries.

By including these categories into the framework of the SNA, a new flexibility is introduced which will, first, help to clarify the treatment of some transactions and, more important, allow producers of national accounts to elaborate macro-economic information on “quasi-liabilities” and “quasi-assets”, in particular in the domain of pension schemes, government guarantees, or non performing loans. The paper remains general and does not analyze case by case the different provisions and the consequences of their inclusion into the scope of the accounts. Also, it does not cover practical issues. The author is far from having the expertise to do that. The aim of the paper is simply to try to open a door which seems to be locked by a (false) debate on principles.

1. Relations between accounting principles

The SNA revision process, which was recently launched by the ISWGNA, is impressive in its scope. However, issues were included in the review program with a view of responding to relatively well known and well delimitated issues. Little effort has been done to broaden the scope to more general issues. One of these broad issues could have been to better analyze the remaining differences in *principles* between the national accounts and the business accounts.

The SNA review guidelines elaborated by the ISWGNA indicate that issues selected for the revision of the SNA should be new issues (i.e. whose problematic has recently appeared). In this context, one could say without contesting that one of the most important new trends in accounting in the last years is the emergence of new *international* standards in business accounting, embodied in the IASB recommendations, which will be implemented in national standards and should even been made obligatory (with some adjustments) for listed EU companies, starting in 2005. No less important for national accountants, *international* standards of *public finance accounting* are also under discussion, under the auspices of the IFAC-PSC. These new standards are not only more international than before but have evolved compared to old national standards, in particular with the increasing reference to the reporting of assets and liabilities on the balance sheet at "fair value", which is equivalent to the preferred valuation of assets in the SNA.

The recent decade has been one of high profile for the national accounts. The SNA 93/ESA 95 was the only *international* accounting guideline to be implemented in practice. IAS and international GAAP did exist but were not systematically applied in accounting standards. In macro-economic statistics, the SNA gained the status of the unavoidable reference. This status was legally recognised by European Union countries, and, further, in Europe and elsewhere, essential policy indicators of public finance have been using its framework (Maastricht criteria and GFS).

At the same time, the SNA, which many users wrongly think is concerned only with the compilation of GDP or household disposable income, has the ambition of covering all aspects of economic accounting. This means not only goods and services accounts (I/O tables), but also complete institutional sectors accounts, and in particular *balance sheets*.

While only a few countries yet publish the complete balance sheet tables (and other changes in volume and reevaluations accounts) that are recommended by the SNA, *conceptually* the structure of the accounts and the recommended treatments regarding institutional sectors accounts are logically based on the central balance sheet concept of *net worth*. This logic is one of the main drivers of the major convergence that was achieved between national accounts and business accounts regarding the principle of *accrual accounting*.

These parallel trends of, on one hand, more international standards in business and public finance accounting, and, on the other hand, more balance sheet information in the macroeconomic accounts is bound to lead to the question of why the principles of these two accounting systems differ, in particular for the calculation of balance sheets.

It is not a coincidence that this issue has already materialized regarding the government sector[1]: this sector is, at the same time, a macro-economic sector (S13 in the SNA) and a "micro-economic" agent (in the sense that there is a body directly or quasi-directly responsible of its accounts[2]). Despite the difference in nature between a government and an enterprise, more and more business sector accounting recommendations are adapted to the government sector. In this context, more and more questions will be raised as to why the national accounts principles differ from the business sector accounting principles adapted to the government sector.

Part of the problematic of the present paper is therefore inspired[3] by the very interesting paper by Lucie La Liberté, presented to the 2004 IARIW conference (see [1] in Bibliography), which illustrates much better and much more extensively than the present paper the domains in which convergence could be reached between national accounts principles and business accounts principles (adapted to government). Another recent paper, from André Vanoli, also much more extensive than the present paper, contributed to the drafting of the present paper [2].

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[1] With the creation of the Task Force on Harmonisation of Public Sector Accounts (TFHPSA), whose explicit mandate is to try to converge with the IFAC-PSC recommendations.

[2] It would be perhaps more appropriate to refer here to S1311, central government, but the idea is the same.

[3] This does not mean that Lucie La Liberté forcibly agrees to the *proposals* that I make in the present paper. I keep of course the entire responsibility of these.

Compared to the vast scope of these excellent papers, the present paper is limited to only one domain of possible better convergence, which is the treatment of *provisions*. In this context, it owes a debt to another excellent paper, prepared by Jean-Paul Milot, which discusses specifically the issue of provisions in national accounts [3].

2. The objectives of the measure of net worth are similar for a single unit…

I suppose that business accountants can give a very simple definition of the *net worth* of the companies that they report for. It is the amount that someone should pay to buy them. This definition is not adapted to the macroeconomic accounts, because, first, they cover institutional units which are not "sellable" (households, government), and second, they report aggregated data. Nobody can nor is willing to buy the net worth of the Nation, often referred as the national wealth.

However, despite this difference in nature, the objective of the national accounts balance sheets is not so different from the objective of the business accountant. The SNA says (13.2): "*for an institutional unit or a sector, the balance sheet provides an indicator of economic status- i.e., the financial and non-financial resources at its disposal that are summarized in the balance sheet item net worth*". While the SNA uses a very general term "*an indicator of economic status*", showing the difficulty to give a more precise definition of the net worth in the context of macro-economic accounts, it, at the same time, explicitly proposes to apply the SNA balance sheet framework to one single unit ("*for an institutional unit*"). It is therefore relevant to compare the *net worth* <u>for a single institution</u> as calculated by the *national accounts* and as calculated by the *business accounts*. We will see later that the problem in macro-economics accounts is the relevance of *aggregating* net worth values.

3…but there are major differences in the principles governing its measure

As is most often the case with statistics and accounting systems, the user will never find the same figure for the net worth of a given unit whether it is calculated by a national accountant and by a business accountant. Several reasons explain this difference. The main one is well known and is described in detail in the section I of the introduction of the SNA[4]. It originates in the difference of valuation of the assets. Based on existing business accounting standards[5], business accountants are deemed to be "prudent" and value their assets at *historic costs*.

As explained in the section I of the introduction of the SNA, national accountants reject this valuation principle on the ground that only valuation at market value (or replacement value, or fair value) can lead to economically meaningful measures. It argues very convincingly that the cost of production (which includes the cost of the use of the capital) valued at historic prices result in a measure of profits which is misleading, because they systematically undervalue inputs compared to outputs. While not stating it explicitly, the SNA also considers that only balance sheets at market value are economically meaningful measures. Here is the good reason for the difference between the principles applied in the national accounts and in business accounting. It is such a good reason, that, as mentioned earlier, the business accounting principles seem to start to converge toward the national accounts principles in this case, with the increasing use of "fair value".

But there is another reason, not discussed in section I of the introduction of the SNA (nor in the rest of the SNA), for the difference in the value of net worth between the national accounts and the business accounting: the treatment of *provisions.* The term *provision* is used here whether it is affecting the

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[4] Section: "Links with business accounting and economic theory".
[5] Which are evolving as mentioned earlier, with the increasing use of the fair value concept.

liability side of the accounts or the asset side of the accounts. In business accounting, it is more appropriate to refer to *provisions* when addressing liabilities and *impairment of assets* when addressing the changes in the value of an asset[6]. We will therefore try to use this more precise terminology in the rest of the paper.

It is the objective of the present paper to try to understand why this difference between SNA and business accounting exists and whether it is justified or not.

4. Some elements and definitions from business accounting

In business accounting, provisions are associated with other words, such as liability, impairment of asset, contingent liabilities. It is necessary to define better these words to clarify the debate. We will use below the definitions of the "IAS 37 Provisions, Contingent Liabilities, and Contingent Assets", as described by [4] and [5].[7]

A <u>liability</u> is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits or service potential.

A <u>provision</u> is a liability of uncertain timing or amount. They should be recognised when a reasonable estimate can be made of the obligation.

A <u>contingent liability</u> is:

(a) a possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity; or

(b) a present obligation that arises from past events but is not recognised because:

(i) it is not probable that an outflow of resources embodying economic benefits or service potential will be required to settle the obligation; or

(ii) the amount of the obligation cannot be measured with sufficient reliability

It is important to note here the gradation in business accounting of the definitions between a present "liability" which is a strong present obligation, a "provision", which is included in the category liability, but is of "uncertain timing or amount", and "contingent liabilities" which are not really obligations because it depends on the occurrence of a future event. An example of a provision given by a business accounting manual is the probable costs of repairs under the guarantee formulated by a machine building corporation to its clients. Based on past experience and future expectations, the company will record a provision equal to the statistical expectation of future payments, based on past statistics of failure.

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[6] However, some business accountants do speak of "impairment provisions".

[7] It should be noted that, while reference is essentially made here to business accounting, there are very advanced proposals to adapt these categories to public accounts. As such, governments will more and more record provisions and contingent liabilities.

The difference between a provision and a contingent liability is that, in the latter case, the possible future outflow of resources is not yet certain, it depends on the future occurrence or non-occurrence of an event which is not in the control of the unit. Another example can be given to illustrate this. A local government entity may have breached an environmental law but it remains unclear whether any damage was caused to the environment. This can be considered as a contingent obligation. Where, subsequently, it becomes clear that damage was caused and remediation will be required, the entity would recognize a provision because the outflow is now probable[8].

The gradation between liabilities, provisions and contingent liabilities corresponds in business accounts to a gradation in reporting requirements. Liabilities are reported in the balance sheet. Provisions are also reported in the balance sheets but as a special category. Contingent liabilities are reported only as memorandum items. Changes in provisions impact the income statement, while changes in contingent liabilities do not.

The clear objective of these recommendations of business accounting is to have units to report the maximum of information on their real and future situation, weighted by probabilities of occurrence of the liabilities, in order to give the most transparent picture of the entity to users of the accounts (essentially shareholders). A lot of effort is made in business accounting recommendations to try to specify the different conditions that allow the classifying of those items into the different categories.

In this context, it seems to me, and this was confirmed by an expert in business accounting [3], that the idea, still quite common among national accountants, that provisions are window dressing categories, whose objective is to help CEOs to present their results to the markets in a way that suit them, is wrong. More and more, provisions are accounting categories that are defined and controlled by auditors, based on written recommendations and jurisprudence.

Regarding *impairment* of assets, business accountants (IAS 36) require that the recoverable value of an asset should be estimated whenever there is an indication that an asset may be impaired. An entity is required to assess at each balance sheet date whether there is objective evidence of impairment. Impairment is identified when the carrying amount of an asset falls below its recoverable amount. An impaired asset should be valued at the higher of its “value in use” or its “selling price”. The “value in use” relies on the estimation of future cash flows associated with the asset, and applying an appropriate discount rate. Losses from the recognition of impairment of assets impact the income statement of the entity[9].

A special case must be made here regarding loans. Under the latest proposed amendments to IAS 39, all financial assets (including loans held to maturity) are to be subject to an “impairment test” at each balance sheet date. If it is probable that the holder of a financial asset will not be able to collect the entire principal or interest amounts due according to the contractual terms, an impairment or bad debt provision needs to be recorded.
This trend is confirmed by a recent paper from the IMF [6], which describes more and more banking supervisory pressure for banks to account for bad loans in a standard way. Owing to this paper:

> (1) Even if they are not internationally standardized, bank accounting rules systematically include recommendations on the classification of loans, from “standard” to “loss loans” through “doubtful”. Regulations tend to be more and more forward looking, in the sense that banks are asked to recognize as soon as possible in their accounts loans that are becoming problematic.

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[8] Or record a liability directly if the amount and timing is certain.
[9] It is possible for this to be avoided by use of an asset revaluation reserve (see IAS 16).

(2) The recognition of bad loans in the accounts is generally based on the creation of a provision in the balance sheet. This provision reflects the estimated loss of the loan value. In banking accounting, the cost of provisions constitutes a normal business expense and reduces bank profit[10].

(3) While the situation may vary from country to country, it is admitted by economists that provisions for bad loans should be recognized as costs by the tax authorities, to provide a strong incentive for banks to adequately provision and to do so in a timely fashion.

Overall, the picture given by business accounting principles on the treatment of provisions, contingent liabilities, or impairment of assets, is one of increasingly detailed recommendations in view of better information on the net worth of the entity, with a subtle gradation between these categories.

From this section, one should retain the difference made between contingent liabilities and provisions, the first having the status of memorandum items, the second being included in the core accounts.

5. Provisions, contingent liabilities and impairment of assets in the SNA

It is surprising, in this context, that the SNA gives so little room to these accounting entries. Basically the SNA rejects all provisions and contingent liabilities in the black hole of "memorandum items".

The principle of the treatment of contingent liabilities and provisions is summarized in paragraph 13.22: "*Two major exclusions [from the list of financial assets and liabilities] should be noted. First contingent assets and liabilities are treated as financial assets only if the claim or liability is unconditional to both parties and/or the arrangement has an observable value because it is tradable. Otherwise, contingent assets or liabilities are not treated as financial assets or liabilities in the System, as discussed in Chapter 11. Secondly, sums set aside in business accounting to provide for transactors' future liabilities, either certain or contingent, or for transactors' future expenditures generally are not recognized in the System (the only "provision" recognised in the System is accumulated consumption of fixed capital). Only actual current liabilities to another party or parties are explicitly included. When the anticipated liability becomes actual –for example, a tax lien- it is included.*"

The SNA definition of "contingencies" can be found in paragraphs 11.25-26: "*Many types of contractual arrangements between institutional units do not give rise to unconditional requirements either to make payments or to provide other objects of value; often the rearrangements themselves do not have transferable economic value. These arrangements, which are often referred to as contingencies, are not actual current financial assets and should not be recorded in the SNA. The principal characteristic of contingencies is that one or more conditions must be fulfilled before a financial transaction takes place. Guarantees of payment by third parties are contingencies since payment is only required if the principle debtor defaults. […].*

11.26. For the purpose of the SNA, the treatment of contingencies is clear. Any payment of fees related to the establishment of contingent arrangements are treated as payments for services. Transactions are recorded in the financial accounts only when an actual financial asset is created or changes ownership. However, by conferring certain rights or obligations that may affect future decisions, contingent arrangements obviously produce an economic impact on the parties involved. Collectively, such contingencies may be important for financial programming, policy, and analysis. Therefore, where contingent positions are important for policy and analysis, it is recommended that supplementary information be collected and presented as supplementary data in the SNA."

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[10] The reverse is true: reducing bad debt provisions increases bank profit.

Nothing much more is said on provisions in the SNA. A thorough scanning of the entire 700 pages of the SNA on the word "provision" (i.e. as an accounting entry) only results in four hits:

- paragraph 10.140 which confirms that provisions for bad debts are not recognized but does not explain why: "*provisions for bad debt are treated as book keeping entries that are internal to the enterprise and do not appear anywhere in the system*".
- Paragraph 13.22 which says "*the only "provision" recognized in the System is accumulated consumption of fixed capital*",
- and paragraphs 12 and 47 of Annex IV which refer to *pension provisions*, but do not discuss them in principle.

In my view, the statement in paragraph 13.22 which says that the only provision recognised is consumption of fixed capital is not only abrupt but is in fact wrong. There are « provisions » which are recognised but not (yet) called « provision » in the SNA: it is all the "non life insurance provisions". The recent report of the task force on the measurement of insurance production recommended that these entries be called explicitly provisions in the SNA. But a part from this detail, one can summarize the recommendations of the SNA based on these paragraphs:

1) only fully recognised non contingent present liabilities are recorded in the accounts,
2) no difference is made between contingent liabilities and provisions, both are excluded from the SNA,
3) impairment of assets such as loans is not recognised,
4) all contingent liabilities and provisions "can" be reported in vague "memorandum" tables[11].

It is interesting to note that the main "contingent liability" referred to in the SNA concerns guarantees (essentially of loans). The SNA is very clear in this respect: guarantees are considered contingent liabilities and are thus excluded from the list of financial assets. This is particularly relevant for the government accounts. Certain governments heavily use the tool of guarantees to, generally, public or partly public enterprises. This exclusion is currently discussed in the Task Force on Harmonization of Public Sector Accounts and in several other fora. The current exclusion of provisions for guarantees in the SNA would probably come as a surprise for business accountants of entities which are specialized in issuing guarantees. For example, export credit agencies make their business in issuing guarantees. The example developed in the previous section on provisions for repair costs leads me to think that the accounts of these entities would show, under business accounting standards, an entry "provision", which amount would be based on the probable occurrence of the guarantee based on past experience. Under business accounting standards, changes in this amount would impact the income statement of such an entity. On the contrary, nothing would happen in the SNA accounts of this entity. This information would be ignored despite its explicit recognition by the economic unit itself. In fact, the treatment of these agencies could be paralleled with the treatment of insurance: indeed, they are the insurers of exporters. If this direction of work is accepted, the provisions for expected losses should enter into the scope of the system and not be excluded, as today.

This general ignorance of provisions becomes more surprising when analysts are more and more interested in building macro-information on provisions and contingent liabilities. For example, the recent Asian and Latin American financial crisis have prompted the international experts on the measurement of external debt statistics to introduce a complete chapter recommending the publication of tables

[11]No country, to my knowledge, publish supplementary tables on provisions and contingent liabilities in the framework of the national accounts.

incorporating contingent liabilities[12]. Also, a recent paper circulated by the European Commission sets a tentative program for the definition, collection and monitoring of contingent liabilities, based in particular on the increasing concern regarding the issuance of non reported government guarantees [7].

6. Why this difference with business accounting on *provisions* and *impairment of assets*?

We have seen in section 4 that one of the main differences between national accounts and business accounts was the *valuation* of assets and liabilities (market price for the SNA, historical price for business accounts). As shown, this difference can be explained for economic reasons: market prices are supposed to better reflect the economic situation of the unit. We have also just seen that both systems exclude pure contingent liabilities from their core accounts. The common sense reason for this exclusion in both systems is that sound accounting should distinguish present *certain* future obligations from possible, *uncertain* future obligations. Analysts should be able to make this difference to assess the net worth of the entity.

What is more puzzling is that the SNA does not make the difference that business accounting makes between provisions and contingent liabilities.

In my view, the reason is probably not that the national accountants are insensitive to the difference of degree between a provision and a contingent liability. From the point a view of a single unit, I see no reason that the amount of net worth in the SNA differs from the business accounting measure regarding the taking into account of provisions and impairment of assets. In other words, if the economic unit recognizes these risks, it is difficult to see the reason that they should not be reported in the macro-economic framework for this entity. This is in particular true for central government, for example.

Thus the key reason for the SNA to reject provisions and impairments of assets outside the scope of the accounts is not that it has a problem with the concept itself, for a given entity. It is that provisions do not satisfy the constraint in national accounts to obtain a "quadruple entry" system, the so-called "symmetry" of the accounts. This is not explicitly explained in the SNA, but has been confirmed by the recent debate on the accounting of non performing loans.

The principle of symmetry is set in one small sentence of the SNA:

Paragraph 2.67: "*again, following the quadruple entry principle, a transaction must be recorded at the same value through all the accounts of both sectors involved. <u>The same principle applies to assets and liabilities</u>*".

In the view of the SNA, provisions and impairment of assets do not satisfy this constraint and thus are rejected. Indeed, provisions and impairment of assets reflect the view of one single institutional unit on its assets and liabilities versus other economic agents which, themselves, maybe do not recognize this probable asset/liability. For example, no counterpart asset "future repairs" is reported by any single client of the manufacturing company which records a provision for probable future repairs in its accounts. At first glance, one could therefore say, that <u>provisions are asymmetric by construction</u>. We will see later that this is not completely true.

In this respect, provisions and contingent liabilities are the same for the SNA: both are "non symmetrical". Thus the gradation between provisions and contingent liabilities of the business accounts is ignored

[12] Joint BIS/Commnwealth/Eurostat/IMF/OECD/Paris Club/INCTD/WB publication (technically, the publication is made by the IMF): External Debt Statistics : guide for compilers and users. http://www.imf.org/np/sta/ed/guide.htm

because both do not fit the symmetry "principle" of the SNA, which is illustrated in several paragraphs of the SNA.

National accountants had therefore to choose between the necessity to follow the "quadruple entry principle" and the situation of "provisions" which are non symmetrical. The SNA 93 has resolved the issue by rejecting provisions outside the system. In particular, impaired loans (also called provisions for bad debts) are excluded from the SNA balance sheets not because this information is not useful but because one cannot apply these provisions to the counterpart party who is the debtor. A provocative critic of the SNA could therefore say that the SNA does not want to show a fair image of the balance sheet of banks (taking into account the provisions for bad debts), only because this image cannot be applied to the corresponding debtor accounts. If this user is only interested in the banking sector, this will certainly appear to him as an insufficient reason.

One important consequence of the non recognition of provisions and impairment of assets is that there are abrupt statements in the SNA that discourage any appropriate treatment of specific events. One of these abrupt statements, for example, is that loans are to be valued at nominal value, in all cases (i.e. even if it is impaired in the creditor's accounts). The consequence of this statement can be illustrated in a recent case treated by Eurostat on financial defeasance. The reference here is Eurostat's "Manual on Deficit and Debt" which is a major interpretative guide to the SNA/ESA for general government accounts. Chapter II.5.2 of this Manual treats the case of a financial defeasance. The Manual presents the situation in the following terms: "*In recent years, there has been instances of public authorities intervening when financial institutions –banks, insurance, corporations or financial groups – have faced difficulties because of their involvement in assets which proved of a bad quality.[…] Intervention of general government may take various forms: […] among which that the government buys directly the bad assets from the financial institutions*."

The manual describes then what to record when the government buys the bad assets at their face value: "*a capital transfer should be recorded when government buys the assets from the financial institutions. The amount of this transfer, paid by government, is equal to the difference between the amount paid for buying them and their <u>true</u> value" (*underlined by me). The Manual then discusses of the methods to estimate the true value (i.e. the market value) of the different assets (which include real estate, shares and loans) but, of course, is obliged to face the specific problem of loans. As government bought back bad loans at their nominal value, one would expect that this should lead to the recording of a capital transfer equal to the difference between the nominal value and the impaired value of the loan, when this loan has been provisioned. But, as explained in the Manual (whose guidelines can only strictly follow the letter of the ESA), this is impossible because the SNA/ESA states that loans have only one value in the System, the nominal value. The Manual is also obliged to recognize that the SNA/ESA states that "*provisions for bad debts […] do not appear anywhere in the system*". Thus the Manual concludes: "*The notion of "fair value" commonly used in business and banking accounting systems, is not recognized for loans in the system of national accounts*"[13].

The apparent consequence is that national accountants cannot record the transaction for these provisioned loans in a similar way as the transaction on other assets because of the definition of the valuation of loans, and despite the fact that business information is given on the true value of the loan when the entity recognizes a provision on the loan!

[13] In passing, the Manual mentions the traditional lack of confidence of national accountants on provisions, which I commented in a previous section: "*Practical considerations also forbid taking into account provisions because they may be subject to manipulations*".

I believe therefore that this situation should not be left as it is. But before trying to propose a solution, it is important to understand why the SNA imposes this “quadruple entry framework” as a superior principle to the one of taking into account the business accounting information delivered by the units.

7. The aggregation problem

As we have seen previously, it is difficult not to accept the argument developed in this paper that the information content of the balance sheet of a single unit will be improved by incorporating provisions and asset impairment. However, national accounts deal essentially with institutional sectors (i.e. the aggregation of numerous institutional units), not single institutional units.

It is easy to show using a very simple example that there is an obvious aggregation problem with balance sheets that include entries with no counterparts. Let’s take the example of the provision for repair guarantee.

Manufacturer M records a provision for repair guarantee for its clients. Its balance sheet appears as:

Balance sheet of M, manufacturer
Assets:
  Non financial assets : MNA
  Financial assets : MFA
Liabilities :
  Shares : MSH
  Financial liabilities : MFL
  Provision for repair guarantee: P
Net worth, *after provision* : MNA + MFA – MSH – MFL **– P**

Here is now the balance sheet of one of the client (C) of this manufacturer, who has a non-zero probability of using in the future the repair guarantee. However, this is not recorded in his accounts, as it is a contingent asset.

Balance sheet of C, client
Assets:
  Non financial assets : CNA
  Financial assets : CFA
Liabilities :
  Shares : CSH
  Financial liabilities : CFL
  Net worth, *after provision* : CNA + CFA – CSH – CFL

Finally, the national accounts will aggregate the accounts of M and C, in the same institutional sector, “Corporations”, and compile its net worth. This is obtained by simple sum of the lines.

Balance sheet of Corporations M+ C
Assets:
  Non financial assets : CNA + MNA
  Financial assets : CFA + MFA
Liabilities :
  Shares: CSH + MSH
  Financial liabilities: CFL + MFL
Provisions: P

Net worth, *after provision*: [CNA + MNA] + [CFA + MFA] – [CSH + MSH] – [CFL + MFL] **– P**

The obvious question is whether it is appropriate or not to subtract P from the net worth of the "Corporations M+C" sector? The answer is that it is probably better to eliminate the impact of the P on the net worth of the total M + C as P has in fact an "implicit" counterpart in the balance sheet of C, the client.

The same type of reasoning could be made on the case of non performing loans, with, on one side, banks recording impairments for bad loans (but not recorded by their clients). Should the net worth of the Nation (= banks + clients) be calculated including the subtraction of those asset impairments (who will possibly benefit in the future to the clients) or not? It seems to me natural to answer that, indeed, the aggregate net worth should not be affected by provisions or by the value of impaired assets *that are internal to the aggregation*. However, the provisions or impaired assets *that are external to the aggregation* remain a relevant value to be subtracted from the net worth of the aggregate. In other words, the net worth of all banks should not take into account bad loans *between banks,* but take into account *bad loans versus the non banking sector*.

Expressed in those terms, I feel the debate can become less theological and more practical. There is clearly a consolidation issue, but this is not sufficient to sustain that a "major principle" of national accounts conflicts with the introduction of provisions and impaired assets in the accounts. If the only problem is a consolidation problem, one should be able to find a flexible way of incorporating provisions in the scope of the SNA, that would allow, at the same time, showing a relevant net worth before and after provision and impairment of assets (versus other institutional sectors).

8. Counterparts are sometimes identifiable, but sometimes not

The first point to be made is that some provisions have, in fact, counterpart recordings, either explicit or implicit. This means that, contrary to what was said previously, provisions are not systematically asymmetric. Jean-Paul Milot [3] explains that provisions can be classified in two categories: (1) *contractual provisions*, which correspond to an obligation towards an identifiable party, (2) *legal or implicit* provisions for which third parties cannot be easily identified when the obligation is created.

In the first case, national accountants should be able to find counterparts and, thus avoid, the aggregation problem. A typical case is the provision corresponding to future pension obligations of employer defined benefits schemes. To this provision, which appears in the sponsor's balance sheet, could correspond, in the national accounts, a quasi-asset by the employees of the firm. In fact, all the discussion of the EDG on pension scheme turns alongside this incorporation of pension provisions in the core national accounts.

The case of impaired assets, and specifically bad loans, is even clearer at least regarding the identity of the third party. In principle, the recognition of the impairment is based on the analysis of the solvency of a given debtor. Thus, by construction, this debtor is an obvious candidate for the counterpart to the value of the impairment. However, it is not obvious that such an adjustment to the net worth of the debtor is a good thing. On a micro-economic basis, the debt continues to appear in its full value in the accounts of the debtor, and not at a reduced value. It is therefore not obvious that the macro-accounts should impose this value to the debtor's accounts. Such a treatment is even most of the time received as a provocation by analysts of the counterpart sectors. More, some specialists argue that such a treatment could have significant adverse consequences on the financial markets. For example, experts of statistics of external debt of developing countries cannot accept that these countries record in their accounts the provisions that are possibly recognised by the rich creditor countries. Debtors are supposed to pay the whole amount, even if creditors think many of them will not be in a position to pay.

The third case is even more difficult. A typical situation would be one regarding the legal obligation made to a firm, for environmental reasons, to dismantle in the future an investment made today. Under business accounting, this firm must record a provision equal to the present value of the cost of the dismantling. In this case, the future outflow corresponding to the cost of the dismantling cannot be attributed to an identifiable counterpart. Nobody knows who, in twenty or thirty years, will be paid for the dismantling. Jean-Paul Milot suggests that national accountants could record the counterpart quasi-asset in the accounts of the general government, which would hold this quasi-asset in the name of society. I must recognize I have not covered all the implications of this proposal.

One can therefore conclude from this section that there are three types of provisions. First the ones for which a counterpart is identifiable, and, at the same time, counterpart entries can be recorded in the accounts. Second, the ones that have identifiable counterparts but for which there is a debate whether it is relevant to *show* this counterpart entry in the accounts. Third, the ones which have no identifiable counterparts.

Let us try to find a practical solution allowing all these provisions to be recorded inside the accounts.

9. Toward a pragmatic solution to incorporate provisions and impaired assets in the SNA

My proposal to incorporate provisions and impaired assets in the SNA is simple: create a table on *changes in provisions* and *impairment of assets* which would come as an additional table, just after the "other changes in volume" account and just before the balance sheet[14]. In addition, the balance sheet would include the traditional value of assets and liabilities under the current SNA valuation rules *plus* the stock of provisions and value of impairments.

The originality of the proposal is that it accepts the principle that these tables are not symmetrical. This is the price to pay for the incorporation of this economic information in the accounts. In my view, it is a small price for a problem which finally boils down into a problem of consolidation. The table would be constituted in three parts corresponding to the three types of provisions described at the end of the previous section.

When, by convention, national accountants agree that a certain type of provision has an identifiable counterpart and that it is relevant to record a counterpart entry in the corresponding institutional sector account, this provision would be recorded so in both accounts. The proposed sub-table would be symmetrical. This situation would correspond for example to the case of the quasi-liabilities of unfunded pension schemes or of social security. The provision is recorded in the accounts of the sponsor and a counterpart entry would be households. One could wonder why these records should not be totally incorporated in the SNA accounts, as transactions, because they appear as symmetrical "transactions". The flexibility introduced by this proposal is that these quasi-liabilities would still be distinguished from the normal liabilities of the SNA, showing clearly their specific nature. As a consequence, they would not be treated as transactions, and in particular would not affect B9 net lending/borrowing (see next section).

When, by convention, national accountants agree that certain type of provisions do have an identifiable counterpart but that it is not relevant to show the counterpart entry in the accounts of the corresponding institutional sector, the proposed tables would not be symmetrical. The provision or impairment would only appear on the account of the institutional sector that covers the entity that recognizes this provision. However, the information on counterparts should not be lost. Using this information, the provisions and impairments would be consolidated. Those that are internal to the published aggregate would be

[14] An alternative which would avoid creating an additional table would be add some specific lines in the "Other changes in volume account"

eliminated. Thus at the end, only provisions and impaired assets that are *external* to the aggregate would be shown.

A typical example of this second situation would be impaired loans. Impairment of loans would be shown as a devaluation of the assets of banks, but would not appear on the balance sheet of debtors, which would remain at nominal value. At the same time, using the information on counterparts, the value of impaired loans would be consolidated. For example, the value of the provisions recorded by banks which correspond in principle to loans to other banks would be eliminated. At the end, the balance sheet of all banks will only show the provisions *on other sectors*, which is the expected relevant information at this level of macro-economic accounts. In other words, this special entry would be, by convention, systematically consolidated. The flexibility of the proposal is that it allows the inclusion of the concept of impaired loans in the SNA following the point of view of the creditor, but avoiding at the same time the aggregation problem and the difficult issue of deciding whether to impose the impaired value to the debtor. As a result, the new SNA would be able to show a better macro-economic indicator than the current one, taking into account the macro-information on bad debts of creditors, without imposing this information to the debtor's account. The same is true of the net worth of the Nation which picture is improved by taking into account the provisions on foreign loans.

There remains the third case of provisions that do not have identifiable counterparts. In this case there is no possibility of avoiding the consolidation problem. In my view, this should not preclude the incorporation of this information in the SNA and the aggregation to be conducted, even if it implies implicit double counting. The advantage of having these provisions inside the scope of the SNA is greater than the disadvantage of showing aggregate values that contain some double counting. After all, the SNA and existing national accounts table already contain many aggregates which include heavy "double counting", as the accounts are not consolidated. An example among many others: the amount of dividends paid by corporations is very often not consolidated and thus contains dividends that are paid to other corporations. This does not preclude the national accountants to publish this figure. In the same way, the amount of provisions that are not "consolidable" will include possible double counting. It does not preclude this information to be useful.

One could consider that my proposal which creates specific entries for provisions and impairment is akin to a memorandum item. In some sense, this is true. As explained my proposal clearly separates the provisions from the rest of the accounts. They come as additional to the existing information, which is not affected by this addition. In that sense, it can be considered as similar to "memorandum items".

But, at the same time, the proposal goes further than traditional memorandum items in that it recognizes the existence of the provision or the impairment in the core accounts. In other words, the SNA would recognize that the existence of a provision for bad loan means that the market value of this loan is probably close to this provisioned value. The SNA would recognize that there are quasi-liabilities of social security systems, and thus foster the estimation of these quasi-liabilities. The SNA would recognize government guarantees, would be able to estimate and record their cost. In that sense, the proposal is more than memorandum items.

10. Conclusion

This paper is certainly incomplete and too general. A case by case study of all provisions would be useful[15]. Also, the paper does not cover the practical issues of collecting information on provisions, and possible counterparts. However, its objective would be achieved if readers would have been convinced

[15] In particular, the complex case of deferred tax provisions should be examined closely.

that there is no “major” principle of the national accounts that should preclude *by principle* the recognition of provisions and impaired assets in the core accounts.

There are certainly some consolidation issues, but the paper shows that they are limited, and that a pragmatic solution can be found that allows making the accounts more informative and useful to users, without affecting the existing core system. In particular, B9 net lending borrowing would not be directly affected by *changes in provisions* or *impaired assets*. It will remain the main balancing item of the part of the accounts that are about *transactions*. Thus provisions and impaired assets would remain separate from *transactions*, which definition would remain unchanged. This is far from a revolution….

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